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J. BARTON RILEY, CFA

"With a Little Help From My Friends"

Wow, here it is the middle of the summer and the markets are supposed to be peaceful and quiet. Instead, the markets are jumping all over the place in super-heavy volume. Financial news has vaulted from the business section to the front page. What the heck is going on? Should we all come back from vacation in order to save our skins?

By and large, most of us can stay on vacation. What we are currently experiencing is a good old-fashioned liquidity squeeze. The world isn't going to end because a modest percentage of sub-prime mortgages are going into default. What's happening is that a lot of institutions are having difficulty correctly valuing their holdings of these new-fangled mortgage-backed securities. This wouldn't be much of a problem, except that old fashioned fear is causing many investors to ask for their money back. How do you give someone their money back, when you can't figure out how to value the securities that the bank bought with it? You don't! You ask for some time to figure out what the investment is truly worth, and then you cash the investor out. This is a liquidity problem more than an asset impairment problem.

My best example of a liquidity squeeze comes from my days as a college student. Remember your friend who was always down to his last few dollars. You lent him a few bucks the first and second time he asked for a loan. If you were lucky, he would pay you back in a week when he received his allowance. But now he's back yet again! Sure, he just got another allowance check from his parents, but it's drawn on their bank in Montana. The check is probably good, but no bank is going to cash it immediately. This is a liquidity crisis! So, being a good friend, who's tired of advancing cash, you cut him a deal. "I'll buy your two new Beatles albums," (yeah, I'm that old) "for half of their original cost." Here's a student, with a check that will to be honored soon, but not immediately, being forced to liquidate some of his treasured music collection at 50% of cost in order to eat today.

On a somewhat larger scale, this is what is happening in the markets this summer. Our 'student' is some sort of hedge fund, who owns a lot of 'really good stuff'. And, because it's a hedge fund, it is probable that the fund bought twice as much of the 'good stuff' by taking out a short-term margin loan. Even though the 'stuff' is really good, the fund can't sell it at a reasonable price in the current atmosphere of fear and uncertainty. This wouldn't be much of a problem except that some of the funds' investors would like to cash out immediately and, at the same time, the bank lending the fund its margin balances would like a bit more collateral. You can't deny your investors' requests because you promised them the ability to liquefy their investment upon notice. And, your banks have the right to ask for more collateral if the market value of your holdings has declined. So, if you were running this hedge fund, what would you do?

Exactly, the fund manager will have to unload some of their unrelated, more-marketable good stuff: the Beatles albums or, more likely, their holdings of far more liquid common stocks. So, even though you and I never owned any sub-prime mortgage backed securities, we are the dubious beneficiaries of the liquidity squeeze that is forcing the sale of marketable stocks by the various institutions that own temporarily unmarketable mortgage-backed securities. We are being asked to provide the liquidity that other institutions need, by being offered additional shares of our favorite stocks at discounted prices. This should be a really good time to be a buyer. Shouldn't it?

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Before we rush to buy a few more shares of our favorite stocks, maybe we should have a look at the severity of the actual problems in the mortgage market. We ought to try to understand what has caused the problems in the sub-prime mortgage market and whether these problems will somehow spread to the far larger area of the more traditional mortgage securities. And, in the end, we need to understand who's to blame for the liquidity crisis that is currently unfolding.

To start at the beginning, let's look at a traditional mortgage. In the olden days, you went to a bank and requested a mortgage loan in order to buy a house. A good, old-fashioned banker would ask you two sets of questions. The first set concerned, what the value of the house is in relation to the amount of the loan that you are seeking? When I bought my first house, the bank would only lend a maximum of 80% of the value of the real estate. The second set of questions focused on whether you had enough steady income to meet your mortgage payments. Even though the bank would only lend you 80% of the value of your new home, they still wanted to see your paycheck stub in order to determine if you could make the monthly payments. As long as mortgage loans were made in this manner, the lending banks had an extremely high likelihood of getting their loans repaid.

The first shift in the mortgage business was the appearance of mortgage insurance policies. First, private mortgage insurers and, later, government related entities ("Fannie Mae and Freddie Mac") came to offer insurance policies that allowed borrowers to reduce their required down-payment to approximately 10% of the home's cost, by proving their credit-worthiness to the insurer and by paying some sort of insurance premium.

The next step in the evolution of the mortgage business was the creation of mortgage pools. These pools allowed multiple lenders to aggregate large numbers of individual mortgages and, thereby, spread the cost of any individual mortgage default among multiple investors. Simultaneously, Wall Street discovered a new business in packaging and reselling interests in these pools to outside investors. And, because the volume of mortgage lending in the United States is so large, the mortgage security business slowly, but surely, became a very important source of profits for the investment banking industry.

Sometime in the past few years, the mortgage banking industry and Wall Street began to get a bit carried away. In order to feed the growing demand for more mortgages that Wall Street could then package and sell to investors, the mortgage bankers and brokers started stretching the definition of a mortgage. They invented "sub-prime" mortgage lending. Sub-prime is a euphemism for borrowers with a lousy or non-existent credit history! By creating sub-prime mortgages, the lenders threw out half of the backing that underlay traditional mortgage issuance. The borrower's ability to make their monthly payments was now ignored. Instead, the mortgage's security now rested solely upon the resale value of the underlying real estate.

Since many investors recognized the increased risk of investing in sub-prime mortgage pools, the mortgage banking industry and Wall Street developed a new way to partially insure investors from the risk of investing in these mortgages. These pools were now 'sliced' into layers of varying risk. The lowest rated layer assumes all the initial default risk. If and when that layer is fully written off, the next layer up begins to suffer the default losses. So, in an oxymoron only an issuing banker could love, the top layer of these things became 'high-grade, sub-prime' mortgage backed securities. And, to top it all off, the issuers actually convinced the rating agencies to assign 'investment quality' ratings to this stuff!

So, today, we have a Rubik's Cube of mortgage backed securities outstanding. While sub-prime mortgages get all the press these days, from my reading it seems that these low quality loans account for less than 10% of all mortgages outstanding. And, according to the chair of the Federal Deposit Insurance Corporation, 85% of these sub-prime loans are still being serviced on time. The problem is that in the Rubik's Cube world of mortgages, the lowest layer of the sub-prime slice of the mortgage market may be close to worthless. In other words, while the whole cube looks pretty good, the little 'sub-cube' in the bottom layer looks pretty rotten. Larry

Kudlow of CNBC, quoting other sources, wrote recently, “less than 1 percent of the entire mortgage portfolio in this country is in default”.

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So, who’s to blame for all this mess and what should we do about it? As you can see from the preceding history of the mortgage security business, the blame must be shared by overly-aggressive issuers, the rating agencies that abetted these issuers, and, finally, the buyers who chased higher yielding debt securities without understanding their basic underlying risks. In the end, I find the most fault with the buyers who had a fiduciary responsibility to fully understand what they were purchasing.

What should we do about this? First, we should allow the financial markets to work through the correct valuation of all of these mortgage securities. Our government shouldn’t bail anyone out! On the other hand, in order for the markets to work, our financial system needs short-term liquidity. The Federal Reserve Bank and other Central Banks around the world are correctly lending a significant amount of short-term funds to the banking system. If that statement eludes you, the Fed is helping the local bank to quickly honor the check on the Montana bank from my earlier metaphor. In the meantime, we’re having a bit of a ‘sale’ in the stock market. Here’s our chance to buy the same stocks that we liked a few months ago at temporarily reduced prices.

One of the Beatles songs from forty years ago was “With a Little Help from My Friends”. Today, we can earn an extra bit of return by helping provide liquidity to our ‘friends’, who aren’t just selling their Beatles albums this time.